

The University of Chicago

AN ANALYSIS OF COMMERCIAL
BANKING IN THE STATE
OF INDIANA

A PART OF A DISSERTATION SUBMITTED TO
THE FACULTY OF THE DIVISION OF THE
SOCIAL SCIENCES IN CANDIDACY FOR THE
DEGREE OF DOCTOR OF PHILOSOPHY

DEPARTMENT OF ECONOMICS
1936

By
MAURICE O'REAR ROSS

Private Edition, Distributed by
THE UNIVERSITY OF CHICAGO LIBRARIES
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CHAPTER I

INTRODUCTION

In the course of the development of commercial banking in the state of Indiana, a multitude of banking institutions of different types have been organized, operated and supervised in a manner quite similar to that of other states of the nation. The system of banking that has developed in Indiana is characteristically composed of, first, a large number of small banks, located for the most part in rural communities of small population. These small banks are of two types primarily--state chartered and private organizations. The larger banks of the state, located in the larger towns and cities, are national banks, larger state banks and loan and trust companies.

All of these banks have been organized and supervised upon that theory of banking which may be described as the liquidity theory of commercial banking. This widely accepted theory would restrict banking operations to short time loans extended to entrepreneurs concerned primarily with the immediate production and transferring of goods and services from the producer to the consumer, in order that these loans would mature regularly and shortly, thus enabling the lending institution to be in a position to liquidate current liabilities existing primarily in the form of demand deposits.

As pointed out frequently by writers on the subject, commercial banking operations have deviated widely in practice from this theory by making long term loans and investments, by repeatedly renewing short term loans, by permitting customers to become continuous and perpetual debtors of the banks and by using earning assets in such a manner that fixed capital has been provided, rather than rapidly maturing current capital, to the communities served.

It is the purpose of the original study, of which this is a summary of the most significant portion, to examine as thoroughly as possible current commercial banking practices and policies in a particular and, it is thought, typical area of the United States, the state of Indiana, wherein there is a marked diversity of economic activity in the fields of agriculture, manufacturing and commerce. This was done not only for the purpose of discovering what these practices and policies are, but to discover how they

have developed and to analyze and evaluate them in the light of banking theory and service rendered.

Procedure

The original study of banking practices and policies in the state of Indiana was divided into four parts.

The first part undertook a broad descriptive survey of the development of commercial banking in Indiana from the time of the establishment of the first crude banking institutions in the territorial days, prior to the admission of Indiana into the Union as a state in 1816, down to the opening of the present century. Only in the light of this background, involving experiments in a state owned monopolistic bank with branches, free banking, the rapid growth after 1873 of a dual banking system composed of national banks operating by the side of and competing with state chartered institutions and private banks, can one obtain a detached perspective of the more recent developments and a proper evaluation of the weaknesses and strength of the system evolved.

While the first part of the original study considered the historical development of the function of banking in Indiana prior to the opening of the present century, the second part, in addition to continuing the discussion of the changing institutional and legislative background of commercial banking during the first three decades of the Twentieth Century, presented a statistical study of the changes that occurred in the number, resources and distribution of earning assets and liabilities of each type of banking institutions as a group operating in the state in the immediate pre-World War, War and post-War periods.

The objects of this statistical study were to inquire into the rapid increase and, later, even more rapid decrease in the number and resources of the various types of banks in the state and the part that failures played in the decline and why and where they occurred. Furthermore, it was the purpose of this section to discover whether or not there existed a tendency among the different groups of banks to tie up an increasing portion of earning assets in security collateral loans and investments, thus bringing about an increasing indirectness in the relation of banks to industry, with an accompanying decline in liquidity. This analysis, moreover, sought to answer the question whether or not a change had occurred in the primary liability of modern banks--deposits--in a shift from demand to time deposits, with a consequent lowering of reserves and an enhancement of the opportunity for additional extensions of credit.

Although the statistical analysis described above indicated

broad changes in the policies controlling the use of earning assets and liabilities of banks and differences between various groups of banks, it did not present a distinction between the practices and policies of banks serving different economic interests, between large and small banks, or between banks located in different areas of the state. It was the object, therefore, of Part III of the original dissertation to make a study of the practices and policies of banks of Indiana serving communities with less than fifty thousand inhabitants. The data for this study were secured primarily by means of a questionnaire sent to all banks of the state located in cities, towns and villages with less than fifty thousand population. A copy of the questionnaire is included in the Appendix to the original study.

The analysis of the practices and policies of the small banks of the state was considered the most significant and essential portion of the entire study. It, therefore, is summarized in detail in the following pages, with a statement of the conclusions arrived at.

The final part of the original investigation dealt with the growth of other types of financial institutions in the state, including building and loan associations and small credit companies. The organization and operation of the Indiana Bankers' Association was discussed, with emphasis placed on the coordinating influence it exercises over the banks of the state. A portion of this section was devoted to the attempt of the General Assembly of Indiana in 1933 to produce a new banking code suited to modern banking conditions. This new code is noteworthy in that it is the result of a prolonged study by a non-political commission of banking conditions in the state and was designed with particular reference to the functions to be performed by the financial institutions of the state, as understood by the members of the commission

CHAPTER II

DESCRIPTION OF THE STUDY OF THE SMALL BANKS OF INDIANA

As stated briefly in the preceding chapter, it is proposed in the present discussion to make a study of the practices of banks in Indiana serving communities with populations of less than fifty thousand. Emphasis will be placed not upon the development of small town banking in terms of changes in number, resources and liabilities, but in discovering actual practices and standards used in the conduct of the banking business in these smaller communities and the changes that have occurred since 1929, as a result of the depression.

The data upon which the study is based have been obtained primarily by means of a questionnaire sent to all banks located in cities, towns and villages of less than fifty thousand inhabitants in Indiana.¹ The questionnaire dealt with the distribution of earning assets of individual banks between loans and investments, with a classification of each, relative amounts of time and demand deposits, interest paid upon deposits, factors governing the length of loans and interest charged, in the period prior to the depression of 1929 and at present--September, 1934. Furthermore, information was requested concerning the action of the banks when their own funds were exhausted and the demand for loans continued, relations with other banks, services rendered to the communities in addition to loans and deposits, effects of the development of good roads and use of automobiles upon the business of the banks, and, finally, the effect of the growth of industrial combinations in the form of chain stores, mergers and similar organizations upon the business of the reporting banks.

A copy of the questionnaire was sent² to 510 banks in the state, including national, state and private banks and loan and

¹A copy of the questionnaire is included in the original dissertation, which is to be found in the University of Chicago Libraries. Due to the size of the city, banks in Indianapolis, Terre Haute, South Bend, Evansville, Fort Wayne, Gary and Muncie did not receive a copy of the questionnaire.

²Questionnaires were mailed on September 4 and 5, 1934.

trust companies. Replies were received from 176 banks, or 30.4 per cent of the total number. Of the number of banks replying, 101 were state banks, 37 were national banks, 24 were loan and trust companies and 14 were private banks. No questionnaires were returned by banks in the hands of receivers, in the process of liquidation or operating upon a restricted basis. At the time of mailing, there were 425 banks operating on an unrestricted basis in the communities of less than 50,000 inhabitants in the state. Replies were received from 41.4 per cent of this number. Of the total 425 banks, 221 were state banks, 107 were national banks, 53 were loan and trust companies and 44 were private banks.

In the course of the discussion, it will be found that many percentages relating to the various phases of the data secured are based upon figures which do not always equal the number of banks reporting. These apparent discrepancies are due to the fact that certain banks replying ignored a question or questions. In the case of a few replies, the answers given were so vague and meaningless that they were not considered in computing results.

Location and Size of the Reporting Banks

Distinct differences occur in the size of the communities in which the various types of reporting banks were located. According to the location of the banks replying, national banks are situated in the larger towns; the state chartered loan and trust companies in somewhat smaller communities; state chartered banks in distinctly smaller towns; while the private banks of the state serve the small villages. Table I on the following page indicates the average size of the communities in which the 176 reporting banks were operating.¹

As a rule, the national banks of the state are doing business in the older and more thickly populated communities of the state, where manufacturing and commercial activities make up a considerable portion of the economic life of the town or city. As far as their trust activities are concerned, loan and trust companies serve industrial and commercial, rather than agricultural interests.

It is interesting to note, however, that 55 of the reporting state banks, or 54.4 per cent of the total number, operated in villages of less than 1,000 inhabitants. Only eleven of these institutions were located in communities of 5,000 or more residents.

¹R. L. Polk, Bankers' Encyclopedia (79th ed.; New York: Polk Bankers' Encyclopedia Company, 1935).

TABLE I

AVERAGE POPULATION OF REPORTING BANK LOCATIONS

Type of Bank	Average Population
National banks	8,306
Loan and trust companies	5,873
State banks	2,379
Private banks	640

Judging from the locations of the reporting private banks, it is equally obvious that these small banks serve even smaller communities. Of the 14 private banks replying, constituting 31.9 per cent of all the private banks of the state on an unrestricted basis, only two did business in towns of more than 1,000 population, while eight operated in villages of less than 500.

The communities in which the state and private banks operate are primarily engaged in agriculture, with little or no industrial activity. It is evident from this analysis, therefore, that the state and private banks of Indiana serve a territory into which other banks have for the most part failed to enter, and, consequently, are not competing as a group with national banks and loan and trust companies.

Not only are there wide variations in the size of the communities served by the different types of banks replying, but the size of the banks and the volume of the business done, measured in terms of average capital, surplus, deposits, loans and discounts and resources employed, show distinct variations, as Table II indicates.¹

TABLE II

AVERAGE CAPITAL, SURPLUS, DEPOSITS, LOANS AND
DISCOUNTS AND RESOURCES OF REPORTING BANKS

Type of Bank	Capital	Surplus	Deposits	Loans and Discounts	Resources
National . . .	\$75,500	\$42,300	\$732,200	\$271,400	\$917,100
Loan and trust	78,400	42,400	727,200	447,500	957,400
State	41,600	21,400	315,100	215,600	400,500
Private . . .	\$19,100	\$14,200	\$183,900	\$113,100	\$229,700

¹Compiled from Polk's Bankers Encyclopedia, 1934.

When measured only by capital stock outstanding, the variations in size of the reporting banks can be seen more clearly.¹

TABLE III

DISTRIBUTION OF REPORTING BANKS ACCORDING TO THE
AMOUNT OF CAPITAL STOCK OUTSTANDING

Capital	National	Trust Co.	State	Private
Under \$25,000	0	0	0	8
\$ 25,000 - \$49,999 .	11	8	76	3
50,000 - 74,999 .	9	5	9	1
75,000 - \$99,999 .	5	3	0	0
\$100,000	10	6	8	0
Over \$100,000	2	2	3	0
Totals	37	24	96*	12*

*Figures for five state and two private banks unavailable.

¹Ibid.

CHAPTER III

POLICIES CONTROLLING THE USE OF EARNING ASSETS

Before the depression of 1929, the major portion of the earning assets of the smaller banks of Indiana were invested in local loans and discounts, judging from the replies of the reporting banks. In fact, the officials of the banks in this group seemed to feel that it was their function to so operate their banks that they might earn dividends for stockholders and then extend aid to the economic progress of their local communities. This attitude is illustrated by many statements made by the officials replying to the questionnaire, a typical reply being that a particular bank was organized "not altogether for the profits that might be in it, but that the community might have banking facilities...." The typical procedure of the reporting banks prior to 1929 was to care for local needs for funds first, then to look for outside means of investment for any surplus assets remaining. Variations from this typical practice, however, occurred. Among the reporting banks are found institutions which disposed of more than 90 per cent of their earning assets in local loans and discounts prior to the depression. On the other hand, there were several banks which reported loans constituting less than 40 per cent of all assets.

Before the depression, the average percentage of total assets devoted to loans and discounts by the reporting national banks was 53 per cent; this percentage amounted to 64.9 per cent for the state banks; 57 per cent for the loan and trust companies; and 60.6 per cent for the private banks replying, or an average for the entire number of reporting banks of 58.8 per cent.

Table IV on the following page classifies the reporting banks according to the percentage of total assets devoted to loans and discounts prior to the depression.

Marked changes occurred in the percentages of total assets used to make loans and discounts by every type of bank reporting, as is indicated in Table V on the following page.

In order to discover the purposes for which loans were made by the reporting banks, the questionnaire asked each institution to classify its loans according to the use of proceeds. Percentages which each type of loans form of the total amount of loans and discounts made are shown in Table VI.

TABLE IV

CLASSIFICATION OF REPORTING BANKS ACCORDING TO THE
PERCENTAGE OF TOTAL ASSETS USED IN LOANS
AND DISCOUNTS BEFORE 1929

Percentage of Total Assets in the Form of Loans and Discounts	National Banks	Trust Companies	State Banks	Private Banks
Under 40%	5	1	4	0
40% - 49	2	3	3	3
50 - 59	5	7	14	3
60 - 69	10	5	20	5
70 - 79	4	2	29	1
80 - 89%	0	1	9	2
90% and above	0	0	3	0
Total	26	19	82	14

TABLE V

CLASSIFICATION OF REPORTING BANKS ACCORDING TO THE
PERCENTAGE OF TOTAL ASSETS USED IN LOANS
AND DISCOUNTS IN 1934

Percentage of Total Assets Invested in Loans and Discounts	National Banks	Trust Companies	State Banks	Private Banks
Under 10%	2	1	1	1
10% - 19	8	0	2	0
20 - 29	11	5	5	0
30 - 39	5	3	21	2
40 - 49	5	5	26	2
50 - 59	3	6	25	1
60 - 69	1	0	10	4
70 - 79	0	0	2	1
80% - 89%	0	0	1	0
Total	35	20	93	11

TABLE VI

PERCENTAGE DIVISION OF ALL LOANS MADE BY REPORTING
BANKS ACCORDING TO USE PRIOR TO 1929

Percentages of All Loans Made for	National Banks	Trust Co's	State Banks	Private Banks
Production of farm crops	19.1%	22.8%	30.7%	42.5%
Stocking goods for merchants . . .	13.5	7.1	8.9	7.5
Manufacturers' operating expenses	6.9	5.6	3.8	1.5
Living expenses	5.1	2.1	2.2	2.0
Feeding livestock	16.2	8.0	18.1	21.9
Farmers cooperatives	1.3	0.0	1.3	2.1
Other purposes	37.9%	54.4%	35.0%	22.5%

It is assumed that the difference between the total of the percentages for the above mentioned working capital purposes and the total 100 per cent of all loans made was for long term and fixed capital purposes. This assumption is supported by the percentage of total assets invested by the reporting banks in real estate mortgages, to be discussed later in this chapter.

By September, 1934, the intervening years of depression had produced changes in the distribution of loans and discounts according to the use of the proceeds as well as in the absolute amount of loans made. The table on the following page indicates the changed distribution when contrasted with the table above.

It is noteworthy that during the five years of depression the percentages of all loans made for the specific purposes mentioned in Tables VI and VII declined in the case of each type discussed. From these two tables it is obvious that the majority of the reporting banks definitely reduced the percentage of all loans made to agricultural interests for working capital purposes between 1929 and 1934. This was a result of the falling agricultural prices, decreasing solvency of farm populations accompanied by a decline in the demand for loans, and the intense desire on the part of most banks of the state to maintain as liquid a position as possible. It is impossible to properly evaluate each of these factors. Some of the reporting banks laid the blame squarely upon supervising authorities, particularly bank examiners, who brought pressure to bear to liquidate "slow" loans. This, in part at least, may merely be evidence of the very human tendency to blame someone else.

TABLE VII

PERCENTAGE DIVISION OF ALL LOANS MADE BY REPORTING
BANKS ACCORDING TO USE AS OF SEPTEMBER, 1934

Percentages of All Loans Made for	National Banks	Trust Co's	State Banks	Private Banks
Production of farm crops	15.5%	18.6%	26.4%	28.0%
Stocking goods for merchants . .	9.7	7.6	4.4	2.8
Manufacturers' operating expenses	4.0	4.6	3.4	1.3
Living expenses	4.5	4.4	2.1	1.8
Feeding of livestock	14.0	6.0	12.9	15.7
Farmers cooperatives	1.3	0.7	0.9	0.7
Other purposes	55.0%	58.1%	49.9%	49.7%

The attitude of the private banks and small state banks operating in the smaller communities seemed to be definitely opposed to extensive lending to local small town merchants. One small town banker summarized this attitude as follows, "credit risks in small country towns were never, as a class, of the highest grade; the depression has made them worse." The increasing number of chain stores in the medium sized small towns has also had an adverse effect. The effect of chain stores on the business of the reporting banks will be discussed later.

Judging from the replies of the reporting banks, it is particularly difficult for the small state and private banks serving agricultural communities to distinguish definitely between credit extended to farmers for the production of crops and the growing of livestock and that used for defraying living costs of the borrower's family. Apparently, many of the small banks made no attempt to segregate productive from consumptive loans. The general attitude of the bankers replying was that consumptive loans, when determined, should not be made or should be kept as low as possible.

An almost negligible amount of loans to manufacturing interests was made either before or during the depression by state and private banks. The volume of such loans made by the replying national banks and loan and trust companies was not much larger. One reason for the small percentage of such loans even among the national banks and loan and trust companies, typically located in larger communities than the reporting state and private banks, is that many of the manufacturing plants in these towns are merely

subsidiaries or branches of parent organizations whose financing is done elsewhere. As one banker stated in his reply, "such organizations increase deposits but decrease loans."

In light of the fact that over three-fourths of the replying banks are located in communities dependent primarily upon agriculture, it is not surprising that working capital loans to agricultural interests play such an important part in the totals. The most commonly used method of securing such loans is the chattel mortgage upon growing crops and livestock. An important reason for the use of this type of security is that many of the borrowers are renters and possess little real property of their own. In the case of loans made to property holders, no security frequently beyond the borrower's single name promissory note and the banker's knowledge of his ability and character is required.

Each reporting bank was requested to state whether or not any attempt was made to so arrange local loans that they would mature in an orderly manner on successive dates, thereby providing the lending banks with a flow of funds with which to meet liabilities and meet additional demands for loans. Of the 152 banks replying, 89, or 58.5 per cent, stated that no attempt was made at any time to so regulate maturities; six banks, or 3.9 per cent, attempted to do so at intervals; and 57 institutions, or 37.5 per cent, did attempt to regulate maturities in order to produce a steady flow of funds. A majority of the banks attempting such regulation were located in communities of more than 1,000 population. The explanation of the lack of an attempt to regulate maturities on the part of many banks is found in the fact that the majority of loans are to agricultural interests and in the nature of the industry can be liquidated only at the end of harvest periods or upon the sale of livestock.

Concerning the purchase of commercial paper in such a manner as to provide regular and successive maturities, of the 151 banks reporting, 109, or 72.6 per cent, either did not make purchases of such paper or made no attempt to regulate the maturities of the amount bought. A larger percentage of the reporting national banks--34.5 per cent--made use of commercial paper and provided for successive maturities than in case of any other type of bank.

All national banks reporting on the subject of paper held eligible for rediscount with Federal Reserve Banks indicated that an average of 33.27 per cent of total loans were of this type prior to 1929; while loan and trust companies reported an average of 43.6 per cent. Many state bank officials replying did not know, some were not interested in knowing, what percentage of loans were eligible. The few state banks replying on this subject

presented an average of 27.5 per cent prior to 1929. By 1933, marked increases had occurred in every case in the percentages of loans eligible for discount.

Real Estate Mortgages

The making of real estate loans on the security of mortgages is almost universal among the banking institutions of all types located in the smaller communities of the state. Of the 154 banks reporting on the subject of real estate loans, only eight stated that they made no real estate loans prior to 1929. The 83 state banks reporting for the pre-depression period indicated an average of 23.7 per cent of all assets in the form of real estate mortgage loans. The reporting national banks presented the smallest average, or 12.2 per cent.

By 1934, a distinct decline had occurred among all types of banks reporting in the percentages of total assets directed into real estate loans. The decreases in the average percentages for each type of bank discussed can be more readily seen in the following table.

TABLE VIII
AVERAGE PERCENTAGE OF ALL RESOURCES DEVOTED TO
LOANS ON REAL ESTATE MORTGAGES BY CLASSES
OF REPORTING BANKS

Type of Bank	1929	1934
National banks	12.2%	8.8%
Loan and trust companies . . .	22.3	15.7
State banks	23.7	17.4
Private banks	11.4%	9.4%

Such loans on the security of real estate mortgages are, typically, long term loans, running from three to five years, and are renewed frequently. It is not the custom of the type of bank being studied to require that the borrower on the security of real estate amortize the loan periodically. It is also obvious that the majority of such loans are made for fixed capital purposes, such as the purchase and improvement of land.

The rapid decline in the value of real estate during the years of depression brought with it serious difficulties for the

banks of the small agricultural communities. As a result of the decline not only in the price of land but also in the price of farm commodities, borrowers were unable to meet interest and principal payments. Much against the wish of bank officials, many banks were required to take over the farms securing loans. One of the important reasons given by the officials of the reporting banks for the large number of failures occurring in Indiana during this period was the decline in real estate and commodity values.

Use of Assets Other than in Loans

All of the banks reporting, regardless of type, were confronted with the problem of the disposition of assets not devoted to loans and discounts. A wide variety of practices concerning funds not loaned locally existed. A few preferred to permit such funds to lie idle in the local bank or in the possession of correspondent banks even during the period before the depression. For the period prior to 1929, the reporting banks presenting intelligible statistics relating to the distribution of assets numbered 142. The average percentage for this group of all assets devoted to other than loans and discounts was 41.2 per cent. With the coming of depression, this percentage increased greatly. By 1934, the average percentage of assets invested in other than loans had risen to 59.2 per cent. The table below presents similar percentages for each type of bank replying.

TABLE IX

AVERAGE PERCENTAGE OF TOTAL ASSETS OF REPORTING BANKS
BY TYPES INVESTED IN OTHER THAN LOANS AND
DISCOUNTS IN 1929 AND IN 1934

Type of Bank	Percentage of Total Assets	
	1929	1934
National banks	47.0%	65.8%
Loan and trust companies .	43.0	63.4
State banks	35.1	55.9
Private banks	39.4%	51.7%

The marked increase in percentage of total assets invested in other than loans and discounts was due to the decline in prices and volume of business with the advent of the depression; borrowers did not renew loans and new borrowers with satisfactory credit

ratings were few. One reporting banker summarized the situation concisely when he stated, "good risks are afraid to borrow and we are afraid of the poor risks."

Several alternative methods of disposing of bank funds not directed into loans and discounts were presented by the reporting banks. The most frequently used means were investments in securities issued by the United States Government, including both long and short term obligations, the obligations of municipalities, general market bonds of privately owned railroads, public utilities and industrial corporations, and bonds of the various instrumentalities of the Federal Government. Additional methods used by a few banks were commitments in commercial paper, and, in fewer cases still, bankers' acceptances.

Before and during the depression, United States Government bonds were an important part of the investment portfolios of the small banks of Indiana, of which the reporting banks were typical. The major portion of these securities were the long term obligations of the government rather than the short term notes and certificates of indebtedness. The average percentage of all resources invested in obligations of the United States Government by 140 of the reporting banks amounted to 8.5 per cent.

By 1934, a marked increase had occurred in the proportion of all assets directed into Federal Government securities. One hundred and fifty-seven banks reported for this year, presenting an average percentage of 15.8 per cent. The following table shows the marked increases occurring in commitments in Government securities after 1929.

TABLE X

PERCENTAGES OF TOTAL RESOURCES INVESTED IN UNITED STATES
GOVERNMENT SECURITIES BY TYPES OF REPORTING
BANKS FOR 1929 AND 1934

Type of Bank Reporting	1929	1934
National banks	12.6%	24.9%
Loan and trust companies	8.3	16.1
State banks	4.9	10.7
Private banks	8.3%	11.6%

The explanation for the rapid rise in the percentages of Government bonds held between 1929 and 1934 lies in the exigencies of the depression, the fear of the bankers and the policy of the

national government. As stated before, loans were paid off and not renewed, the credit standing of all borrowers declined, other loans became uncollectible. Bankers in smaller communities were particularly bewildered. Lacking diverse industries to which to lend and confronted with rapidly falling agricultural prices, these bankers turned more and more to Federal Government bonds, actuated by motives expressed by the one remaining bank in a town of over 5,000 population, "Government bonds are the only thing left that we can put our depositors' money into and feel fairly sure of getting it back." Judging from the replies of the reporting banks, many officials had gone to the extreme of refusing all local loans and seeking safety in other commitments. Typical of these replies were, "making no loans at present"; "have made no new loans for nearly a year."

The policy of the Federal Government in financing repeated and growing annual deficits through bond issues sold to banks has likewise been a factor in the increasing relative importance of Government bonds in reporting bank folios.

By 1934, a shift occurred toward the investment of a larger percentage of funds in the shorter term securities of the Federal Government in the form of short term notes and treasury bills. The reasons for this shift were apparently the increase in the volume of such obligations, the opinion of many of the reporting bankers that the long term bonds would decline more when interest started rising from the low levels of 1934, and the fear that long term bonds may decline in value with a continuation of the depression and the increasing necessity of Government borrowing.

It is interesting to discover that the percentage of all banking assets of the reporting banks invested in municipal obligations remained approximately the same in 1934 as in 1929. At no time was the percentage of such securities large for any type of bank. Table XI on the following page presents the changes occurring in the proportion of all resources directed into municipal obligations before the depression and in 1934.

The reason for the small percentage of total resources invested in municipal securities even during the pre-depression period is found in the fact that municipal securities as a group do not have the high degree of marketability possessed by the obligations of the Federal Government. Many of the municipal securities are not listed on organized exchanges and do not possess active markets with close bid and asked prices. Moreover, wide variations occur in the solvency and credit rating of the issuing bodies and the record of municipal securities has been marked by many serious defaults and other difficulties.

TABLE XI

PERCENTAGES OF RESOURCES INVESTED IN MUNICIPAL
OBLIGATIONS BY TYPES OF REPORTING BANKS
IN 1929 AND IN 1934

Type of Bank	1929	1934
National banks	6.4%	4.8%
Trust companies	3.5	3.6
State banks	2.3	2.8
Private banks	4.9%	2.9%

Only five of the 176 reporting banks stated that they made use of bankers' acceptances as a medium of investment. Four of the five banks were among the largest in their particular groups. By 1934, however, only one of these banks was continuing to make use of such obligations. In addition to the unfamiliarity with bankers' acceptances as a means of investment among the small banks of Indiana, there must be mentioned the fact that such instruments ordinarily bear a low rate of return.

A miscellaneous group of other instruments were used as channels of investments by a few of the reporting banks. Of this miscellaneous group, the most frequently mentioned were Federal Land Bank bonds. A reply from one banker, typical of others, stated that he received a better yield from these securities than from any other held. The equipment trust notes of leading railroads, the obligations of the Home Owners Loan Corporation, the bonds of industrial and public utility corporations, and "high grade general market bonds" were mentioned occasionally as investment media. Of the entire number of banks studied, only one--a state bank located in one of the largest cities of the group under consideration--made use of the New York call loan market as a field in which to invest surplus funds.

One of the most interesting discoveries made from the replies of the various banks concerning "the disposition of funds not needed in local loans and discounts" was the fact that a comparatively large number made no use whatever of surplus funds, but permitted them to lie idle.

Summary

It is evident that the loan accounts of the reporting banks are composed primarily of local loans. Commercial paper

and call loans are found hardly at all among them. A significant characteristic of the loans made is that such a small percentage is in the form of commercial loans. The bulk of the loans made by the reporting banks are granted to agricultural interests and run ordinarily for periods of nine months or more and are very readily renewed. Inevitably, such local loans offer little opportunity for diversification or for the control of maturity dates in such a manner to provide a regular flow of funds to meet current liabilities. Whatever diversity is secured must be derived from investments in securities of various types. The need for diversification has undoubtedly been a factor in the increasing importance of security investments.

A large portion of all loans granted by these banks are for long term, fixed capital purposes. These loans are secured by mortgages and frequently run from three to five years and are renewed frequently on expiration. Not only are many of the loans made not easily and regularly liquidated, but neither do they possess the quality of shiftability to any marked degree to other banks in time of need. Only a very small portion of all loans made by the small banks studied were eligible for rediscount with Federal Reserve Banks. Only two of the reporting non-national banks were members of the Federal Reserve System.

As far as loans are concerned, the resources of these banks have been unavoidably tied up in assets that, for the most part, are illiquid and long term in nature, due to the nature of the industry served. Neither can the increasing quantity of securities held be depended upon for the desired degree of liquidity, since such obligations cannot be liquidated in periods of general emergency, excepting at substantial losses, which the small equity interest of the typical reporting bank could not absorb. Hence, the small country banks of Indiana are in a position where the bulk of their assets are of a non-liquid, long term nature, while practically all liabilities, including time deposits, are current in character.

CHAPTER IV

INTEREST RATES CHARGED AND PAID BY THE REPORTING BANKS

In spite of the increasing importance of security investment, the most important single source of revenue of the banks being studied is the interest rate charged to local borrowers. Likewise, one of the most important sources of expense has been the payment of interest upon deposits of various types.

This chapter is devoted to the discussion of interest rates charged by the reporting banks and interest paid depositors, followed by an analysis of changes occurring in such charges and payments. An additional discussion of the factors determining interest rates charged will be presented.

Interest Rates Charged by the Reporting Banks

The Constitution of Indiana, adopted in 1851, specifically states that "no bank shall receive, directly or indirectly, a greater rate of interest than shall be allowed by law to individuals loaning money."¹ Since the adoption of the Constitution, the legal rate of interest has varied only slightly. From 1901 to the present, the legislature has fixed the maximum interest rate to be charged by lenders of money at eight per cent per annum.²

Since the rates of interest charged by national banks are indirectly regulated by the laws of the state in which they do business, the legal limit set by the laws of Indiana applies to all banks of the state.³ All banks are permitted to charge for services rendered in addition to the legal rate permitted, and "no compensation or commission paid or agreed to be paid for the negotiation of any loan or the execution of any trust by any corporation (bank or trust company) shall be deemed to be interest within the meaning of any law of this state...."⁴

¹Constitution of the State of Indiana, 1851, Article 9.

²Acts of Indiana, 1929, p. 804.

³National Bank Act, Sec. 5197.

⁴Financial Institutions Act of Indiana, 1933, Sec. 182.

Of the reporting banks, 159 replied concerning interest rates charged customers. No institution reported an interest rate in excess of the legal rate of eight per cent. Six banks, however, five state banks and one trust company, reported a constant rate to all borrowers of eight per cent. It is noteworthy that an overwhelming number of the reporting institutions maintained constant interest rates with no apparent distinction, from the standpoint of the rate charged, between loans of different size or of different degrees of risk. Of the total number, 105, or 66 per cent, made no attempt to vary the rate of interest at any time charged on loans. Of the 54 banks which varied rates to any extent, 35, or 64.8 per cent, did so between the limits of 6 to 7 per cent, while 19 varied rates between the broader limits of 6 to 8 per cent. Sixty-seven of all banks reporting, or 42.1 per cent, maintained rates constant at 7 per cent. The following table presents this data more concretely.

TABLE XII
INTEREST RATES CHARGED BY REPORTING BANKS

Interest Rate	National		State		Trust Co.		Private		Total
	V	NV	V	NV	V	NV	V	NV	
4% to 8% . . .	1	0	0	0	0	0	0	0	1
5 to 7 . . .	1	0	0	0	0	0	0	0	1
6 to 7 . . .	8	0	14	0	1	0	2	0	25
6 to 8 . . .	6	0	6	0	3	0	4	0	19
7 to 8% . . .	0	0	7	0	1	0	0	0	8
6	0	10	0	14	0	4	0	1	29
7	0	7	0	44	0	12	0	4	67
8%	0	0	0	8	0	1	0	0	9
Total . .	16	17	27	66	5	17	6	5	159

V: Variable Rates, as indicated in replies to questionnaire.

NV: Non-Variable rates.

Total number of banks having non-variable rates . . . 105

Total number of banks having variable rates 54

As indicated in the preceding table, there were 37 banks with interest rates at or up to 8 per cent. Of this number, 27, or 72.8 per cent, were located in communities of 1,000 inhabitants or less. It is also noteworthy that there were only ten banks charging rates at or up to 8 per cent that had capital outstanding in excess of the minimum permitted for each type, and of

this ten there were five that barely exceeded the minimum limitation.

Further analysis of the size of the banks reporting and of the communities in which they are located reveals the fact that of the 29 institutions reporting a flat rate of six per cent, 25 had capital outstanding in excess of the minimum requirements set by law, while 21 of the 29 banks had capital equal to or in excess of \$50,000. Twelve of the 29 were operating in communities of 5,000 or more population. Only two of these banks operated with a non-variable rate. It can be concluded that the highest and non-variable interest rates were charged by the smaller banks.

Factors Determining Interest Rates Charged

It is extremely doubtful that the rediscount rates of the Chicago or St. Louis Federal Reserve Banks have any important influence on the rates of interest charged by the reporting banks. This is true even of the reporting national banks. Of the 31 national banks replying concerning the influence of the rediscount rate, 29, or 94.6 per cent, declared that it had no influence. Only six of the 89 state banks admitted that their rates were affected by the rediscount rate.

The dominant factor determining the rate charged apparently is not the risk involved, nor operating costs directly, nor the demand for or the supply of funds available, but local custom and habit. In reply to the inquiry concerning the extent to which interest rates charged have varied since the World War, 92 of the 138 banks reporting, or 66.6 per cent, stated that no change in interest rates charged whatever had occurred. Of the 46 indicating changes, 18, or 39.1 per cent, had increased the rate; another 18 had decreased rates, while ten did not indicate the direction. The following table presents the data in summary form.

TABLE XIII

CHANGES IN THE INTEREST RATE ON LOANS BY REPORTING BANKS
FROM THE WORLD WAR TO SEPTEMBER, 1934

Type of Bank	No Change	Increased	Decreased	Changed	Total
National . . .	19	3	3	3	28
State.	52	10	11	7	80
Trust company	16	3	0	0	19
Private . . .	5	2	4	0	11
Total . . .	92	18	18	10	138

Many of the replying officials definitely stated that custom is the dominant factor in setting rates of interest charged. One of the more interesting of the many statements made was the declaration of a small state bank whose interest rate had not varied since the organization of the bank prior to 1914, "seven per cent is like the law of the Medes and Persians."

This marked fixity of interest rates among the small banks of the state is explained on the part of the bankers themselves by the fact that the local demand for loans, both short and long term, is highly inelastic. The officials feel that there are only a certain number of good credit risks in each community and that interest cost, even at the prevailing high rates, is only a small part of total costs. Therefore, according to their reasoning, prospective borrowers will not be deterred from borrowing by high interest rates when they see a chance to profit, nor increase borrowings by low interest rates. These officials admit readily that wide variations occur in the amounts borrowed from year to year, but they assert that these fluctuations are caused by seasonal and cyclical conditions unrelated to the local interest rate.

Economic theory would indicate that, if competition existed among the lending banks and if the demand for credit was inelastic, slight variations in the amount taken would produce wide variations in the interest charged. The fact that these variations do not occur in the case of the interest rates charged by the reporting banks tends to indicate that a considerable degree of monopoly is in effect among the lending institutions. Ordinarily, there are few banks in each community and in many communities the reporting bank was the only one in operation. The typical borrower from the reporting banks has been unable, until recently, to go beyond the community where he is known to secure credit. Moreover, the fact that the local borrower is accommodated frequently only if he maintains a balance in a bank tends to limit "shopping around" for funds.

Economic theory would indicate, furthermore, that the charging of a constant rate by the reporting banks would, in the long run, influence the amount borrowed from local banks and from sources outside the local community. Small community bankers readily admit that there has occurred an increase in installment buying and that business, including some of the local banking business, is being transferred to more metropolitan centers. They do not admit, however, that any material portion of the lost business would be returned to them by lowering interest rates. They attribute the movement to large centers to all those developments producing a greater degree of integration in society, including

good roads, automobiles and improved communication facilities, resulting in the decline in small, isolated communities.

Although custom, habit and a degree of monopoly seem to be the primary factors determining the rate of interest charged by reporting banks, the type of loan made and the risk involved enter in. As has been stated repeatedly, the major portion of the business performed by the reporting banks is with agricultural interests, where credits must be for longer terms and where payment is dependent upon many fortuitous circumstances, such as rainfall and frost and other causes of crop success and failure. Mortgage security avails little in the face of world economic conditions producing long periods of stagnation and declining prices. Moreover, the fact that the demand for agricultural products is typically inelastic tends to accentuate price fluctuations resulting from relatively small changes in supply. All of these conditions, therefore, tend to make the agricultural industry and dependent industries highly speculative in character. Hence, it is not surprising that one of the factors determining the nominal rate of interest set by some of the reporting banks is the element of risk. The speculative aspects of such loans are illustrated by the statement, typical of many others, made by an official of a small state bank doing almost all of its business with farmers, that, "with us the risks of collection maintain an eight per cent rate." It is, apparently, an almost universal practice among the banks varying interest rates at all to charge at or near the maximum legal rate for small loans.

A third factor determining the interest rate charged customers is the cost of operating the bank. One bank official made a statement, similar to others, illustrating a policy that is in striking contrast to the practice followed by other businesses similarly situated, "we have less loans, and due to added expenses and costs of operation, rate has been increased." The operator of a small private bank explained interest rates charged ranging from six to eight per cent by "the need for income to pay expenses and a meager profit."

In the process of determining interest rates, another factor considered by many of the banks replying was the worth or value of the borrower's business to the lending institution. Although no definite rules seemed to be followed by the reporting banks, the practice of allowing a somewhat lower rate of interest to the customers who maintained "satisfactory" balances on deposit seemed to be widespread. The same practice is expressed in another way by the generally followed custom of charging the non-customer a higher rate than the regular client.

It is surprising how few of these banks consider economic

conditions outside their local situations as important factors affecting local interest rates. Of the 53 state banks presenting a detailed list of factors affecting interest rates, not one listed outside economic or financial conditions. Only among the reporting national banks is there any evidence that outside economic conditions are taken into consideration in connection with local interest rates. In only three cases out of 138 banks reporting on the subject was competition mentioned as a factor in determining interest rates. There is some evidence to show that there exists a "community of interest" in relation to interest rates charged. Many statements were given similar to the following, "the customary rate of the _____ County Bankers' Association," and "the uniform rate charged by all surrounding banks."

Specific mention was made by nine banks of the rate paid by the local bank on time and demand deposits as a factor in setting the interest rate charged. This element of cost, however, seems to be relatively unimportant in determining interest rates charged, since such rates ordinarily have approached the legal limitations as a consequence of other conditions before it becomes necessary to pay out interest in order to attract additional deposits.

Both before 1929 and in the year 1934, it was almost universally true that the reporting banks borrowed from their clients and from local municipal governments through the process of paying varying rates of interest upon time deposits. A much smaller proportion of the banks, even in 1929, paid interest upon demand deposits. In 1929, 135 of the 136 banks reporting paid interest upon time deposits of individuals and business organizations, while 124, or 91.8 per cent, paid the required legal rates on the deposits of public funds. Only 36 of the 136 reporting banks, or 26.4 per cent, in 1929 paid interest upon demand deposits. By September, 1934, however, no marked change had occurred in the percentage of banks paying interest upon time deposits of individuals and municipalities, but a very marked decline had taken place in the number paying interest on demand deposits, as is shown in Table XIV on the following page.

As a consequence of the passage of the Glass Steagall Act of June 16, 1933, the payment of interest on demand deposits by banks which are members of the Federal Reserve System is prohibited, with the exception of public deposits, on which the payment of interest is required by law. The expediency, therefore, of paying interest upon such deposits is no longer debatable. On January 19, 1934, the Federal Deposit Insurance Corporation issued regulations of a similar nature. Since these two organizations include among their members practically all banks, the payment of

TABLE XIV

INTEREST RATES PAID BY THE REPORTING BANKS
ON DEPOSITS IN 1929 AND 1934

Rate of Interest Paid	Individual Time Deposits		Individual Demand Deposits		Public Funds	
	1929	1934	1929	1934	1929	1934
2% and under . .	1	21	18	11	93	129
2 to 3%	0	28	0	1	10	5
3	23	105	3	1	16	5
3 to 4%	0	0	1	0	0	0
4%	112	0	14	0	5	0
Total	136	154	36	13	124	139
None Paid. . .	1	2	100	136	11	12
Grand Total	137	156	136	149	135	151

interest on demand deposits remains a subject of only academic interest. Table XV on the following page breaks up the totals of the preceding table into the number of banks belonging to each group discussed.

It is worthy of note that in 1929, 81.7 per cent of all reporting banks were paying 4 per cent or higher on time and savings deposits. Of the reporting state banks, 88.8 per cent paid this high rate, while only 59.2 per cent of the national banks did so.

The Relation of Time Deposits to Total Deposits

It is the purpose of this particular section to inquire into the practices of the reporting banks concerning the proportions of total deposits carried in the form of time deposits and savings accounts before and during the depression, variations between the different classes of banks, and variations, if any, between the size of the communities served.

Before the depression, the reporting national banks maintained a larger percentage of total deposits in the form of time deposits than did any other type of bank, as is indicated in Table XVI.

These average percentages of time to total deposits for

TABLE XV

INTEREST RATES PAID BY THE REPORTING NATIONAL, STATE,
TRUST COMPANY AND PRIVATE BANKS IN 1929 and 1934

(a) On Time Deposits														
Type of Bank	4% and above		3 to 4%		3%		2 to 3%		2% or under		None Paid		Total	
	'29	'34	'29	'34	'29	'34	'29	'34	'29	'34	'29	'34	'29	'34
National	16	0	0	0	10	16	0	9	1	7	0	0	27	32
State	72	0	0	0	8	66	0	15	0	10	1	2	81	93
Trust	15	0	0	0	3	15	0	2	0	3	0	0	18	20
Private	9	0	0	0	2	8	0	2	0	1	0	0	11	11
Total	112	0	0	0	23	105	0	28	1	21	1	2	137	156

(b) On Demand Deposits														
National	0	0	0	0	2	0	0	0	6	3	16	28	24	31
State	11	0	1	0	1	0	0	1	9	6	61	81	83	88
Trust	2	0	0	0	0	1	0	0	3	0	13	18	18	19
Private	1	0	0	0	0	0	0	0	0	2	10	9	11	11
Total	14	0	1	0	3	1	0	1	18	11	100	136	136	149

(c) On Public Deposits														
National	1	0	0	0	3	0	5	3	15	24	2	5	26	32
State	3	0	0	0	11	4	5	2	55	78	5	4	79	88
Trust	0	0	0	0	1	0	0	0	15	18	3	2	19	20
Private	1	0	0	0	1	1	0	0	8	9	1	1	11	11
Total	5	0	0	0	16	5	10	5	93	129	11	12	135	151

all the various groups of banks do not at all indicate the very wide variations that occurred in the relation of time and demand deposits among the individual banks in each group. The extent of these variations is indicated in Table XVII on the following page.

Eight national banks reported that time deposits in 1929 constituted 60 per cent or more of all deposits. Six of these were situated in communities smaller than the average for national banks, while four were located in communities of 1,000 population, or less. In 1934, eight national banks again reported time deposits equal to or in excess of 60 per cent, seven of which operated in communities smaller than the average, two being in villages

TABLE XVI

PERCENTAGE OF TIME TO TOTAL DEPOSITS OF REPORTING
NATIONAL, TRUST, STATE AND PRIVATE BANKS
IN 1929 AND IN 1934

Type of Bank	1929	1934
National banks	42.7%	43.2%
Trust companies	40.9	37.0
State banks	39.1	38.6
Private banks	32.1%	39.9%

TABLE XVII

DISTRIBUTION OF REPORTING BANKS ACCORDING TO THE
SIZE OF PERCENTAGES OF TIME TO TOTAL DEPOSITS
IN 1929 AND 1934

Percentages of Time to Total Deposits	National		State		Trust		Private		Total	
	'29	'34	'29	'34	'29	'34	'29	'34	'29	'34
None	0	0	10	0	2	0	1	0	13	0
1% - 9% . .	0	1	1	2	0	1	1	1	2	5
10 - 19 . .	1	2	6	5	0	0	1	0	8	7
20 - 29 . .	3	6	7	19	3	6	1	2	14	33
30 - 39 . .	2	5	11	23	4	4	3	1	20	33
40 - 49 . .	6	4	12	14	0	2	0	2	18	22
50 - 59 . .	5	6	14	12	2	5	1	1	22	24
60 - 69% . .	6	6	8	9	4	2	1	3	19	20
70% and above	3	3	10	6	1	0	1	0	15	9
Totals . .	26	33	79	90	16	20	10	10	131	153

of less than 500 inhabitants.

In 1929, two small state banks with minimum capital, each located in a rural village of 800 population, reported that 100 per cent of all deposits were in the form of time deposits. The highest percentage reported for state banks in 1934, however, was 75 per cent. Seventeen state banks reported that time deposits

formed 60 per cent or more of all deposits in 1929; fourteen of these being located in villages of 1,300 or less. Of the thirteen state banks reporting similar percentages in 1934, eleven were operating in villages of less than 1,000 population.

This analysis of the location of banks reporting banks having very large portions of all deposits devoted to time deposits--60 per cent and over--indicates that, typically, they are small institutions, located in and serving very small communities. This was true in the pre-depression period of 1929 and in the depression year of 1934. The wide disparity between the reserve requirements in the case of the state controlled banks for time and demand deposits is an influence to be considered in inquiring into the reasons for the existence of such large proportions of all deposits being devoted to time accounts. In 1929 and in 1934 the state banking law of Indiana required that all banks and trust companies under its jurisdiction should maintain minimum reserves of 12.5 per cent of aggregate demand deposits and 3 per cent of time deposits.

Prior to the banking moratorium of 1933, it was the general practice of the smaller banks of the state to permit the holders of time deposits to withdraw them at will without notice. This practice apparently was the result of competition, rather than a conscious attempt to facilitate the shifting of demand into time deposits.

Cash in Relation to Deposit Liabilities

Since national banks and other banks that become members of the Federal Reserve System are required by the Act to maintain all legal reserves on deposit with the Federal Reserve Banks, and as a result of the facility with which such member banks may secure additional funds on short notice from the Federal Reserve Banks, it is not surprising to learn that the twenty-six national banks reporting for the year 1929 maintained a smaller percentage of deposits in the form of cash on hand than in the case of any other type of bank discussed. This percentage amounted to 6.7 per cent. Among reporting state banks, however, none of which was a member of the Federal Reserve System, legal reserves required by the state legislation were kept either in their local vaults or on deposit with correspondent banks. The 78 state banks replying concerning cash on hand for 1929 reported an average percentage for the group of 9.1 per cent.

By September of the depression year 1934, heavy increases had occurred in the percentages of cash on hand in the case of all banks investigated, as is indicated in the following tables.

TABLE XVIII

PERCENTAGES OF CASH ON HAND TO ALL DEPOSITS OF
REPORTING BANKS IN 1929 AND IN 1934

Type of Bank	1929	1934
National banks	6.7%	13.2%
Loan and trust companies . . .	7.1	11.3
State banks	9.1	17.7
Private banks	7.4%	13.1%

Wide variations occurred between individual banks in regard to the amount of cash maintained in relation to deposits. The desire for liquidity in 1934, combined with inability or unwillingness to make use of funds available, resulted in percentages maintained at very high figures. The variations may be seen in the table below.

TABLE XIX

PERCENTAGES OF CASH ON HAND TO DEPOSITS MAINTAINED
BY INDIVIDUAL REPORTING BANKS IN 1929 AND 1934

Percentages Cash on Hand	National		State		Trust		Private		Total	
	'29	'34	'29	'34	'29	'34	'29	'34	'29	'34
1% - 4% . . .	12	15	33	33	9	4	5	3	59	55
5 - 9 . . .	6	4	10	12	3	9	0	3	19	28
10 - 14 . . .	2	3	11	5	2	1	3	1	18	10
15 - 19 . . .	4	0	8	1	1	0	1	0	14	1
20 - 24 . . .	2	4	10	7	0	0	1	0	13	11
25 - 29 . . .	0	1	3	4	0	1	0	2	3	8
30 - 39 . . .	0	1	1	7	1	2	0	0	2	10
40 - 49 . . .	0	2	0	11	0	1	0	1	0	15
50 - 59% . . .	0	2	0	4	0	0	0	0	0	6
60% and over .	0	0	0	3	0	0	0	0	0	3
Totals . .	26	32	76	87	16	18	10	10	128	147

Of all banks reporting as of 1929, eighteen, or 14.1 per cent, carried cash on hand equal to or in excess of 20 per cent of all deposits. By 1934, however, 53 banks, or 36.1 per cent, maintained cash on hand equal to or in excess of 20 per cent of deposits. As is indicated in the preceding table, a larger percentage of state banks replying maintained this relatively high cash reserve on hand--18.4 per cent of the entire number in 1929 and 41.3 per cent in 1934. The reporting national banks permitted the proportion of their number carrying 20 per cent or higher cash reserves to rise from 7.7 per cent in 1929 to 31.2 per cent in 1934. The corresponding percentages for trust companies and private banks were, for 1929, 6.2 per cent and 10 per cent in the order named, and 22.2 per cent and 30 per cent, respectively, in 1934.

As far as the reporting state, trust company and private banks are concerned, there is rather conclusive evidence to show that the banks maintaining excessively high cash reserves on hand in 1934 were located in the very small communities of the state. Of the 36 state banks reporting cash on hand equal to or in excess of 20 per cent of deposits, 29, or 80.5 per cent, were operating in communities with populations smaller than the average for the reporting state banks as a group; furthermore, 24 of the 29 banks were situated in villages of less than 1,000 population. Not one of the 29 institutions had capital outstanding in excess of \$35,000. Three of the four trust companies and two of the three private banks reporting excessive reserves on hand were located in communities with below the average population for their respective groups. Of the ten national banks with excessive reserves, five operated in smaller than the average communities; one in an average size town; while four were located in larger than the average communities.

The funds deposited with correspondent banks by the reporting banks vary with and are affected by the same seasonal and cyclical conditions that govern cash on hand. The same tendency to increase occurred in the percentages of all deposits kept with correspondent bank balances by the various types of reporting banks between the years 1929 and 1934, as can be readily observed in Table XX on the following page.

Again, the reporting state banks present, in 1934, the largest percentage of all deposits in the form of correspondent balances. Table XXI indicates that correspondent balances held by reporting banks varied more widely as between banks and classes of banks than in the case of cash on hand.

Of the 131 banks reporting for 1929 concerning correspondent balances, 38, or 29 per cent, carried balances equal to or in

TABLE XX

PERCENTAGES OF ALL DEPOSITS MAINTAINED IN BALANCES
WITH CORRESPONDENT BANKS BY REPORTING BANKS
IN 1929 AND IN 1934

Type of Bank	1929	1934
National banks	13.9%	27.1%
Loan and trust companies . . .	16.2	26.2
State banks	15.9	29.8
Private banks	16.7%	25.7%

TABLE XXI

DISTRIBUTION OF REPORTING BANKS ACCORDING TO THE
PERCENTAGES OF CORRESPONDENT BALANCES TO ALL
DEPOSITS IN 1929 AND 1934

Percentages	National		State		Trust		Private		Total	
	'29	'34	'29	'34	'29	'34	'29	'34	'29	'34
1% - 4% . . .	1	0	2	0	1	1	0	0	4	1
5 - 9 . . .	2	1	11	3	3	1	0	0	16	5
10 - 14 . . .	13	5	25	6	4	2	4	0	46	13
15 - 19 . . .	4	5	17	14	3	3	3	0	27	22
20 - 24 . . .	3	6	14	12	3	2	2	3	22	23
25 - 29 . . .	1	2	4	5	2	3	0	5	7	15
30 - 39 . . .	1	5	3	26	0	4	1	2	5	37
40 - 49 . . .	0	2	3	10	1	1	0	0	4	13
50 - 59% . . .	0	3	0	5	0	1	0	0	0	9
60% and above .	0	2	0	4	0	1	0	0	0	7
Totals . .	25	31	79	85	17	19	10	10	131	145

excess of 20 per cent of all deposits. By 1934, it is to be noted, 104 banks of the 145, or 71.7 per cent, maintained such balances. Analyzing the figures by classes of banks, it is discovered that 100 per cent of the private banks replying for 1934 carried balances with correspondents equal to or in excess of 20 per cent of deposits. In 1929, however, only 30 per cent carried such balances. In 1929, 30.8 per cent of the reporting state

banks possessed balances with correspondent banks at or above the 20 per cent level; by 1934, this percentage had risen to 72.9 per cent. The replying national banks and loan and trust companies indicated that in 1929, 25 and 35.3 per cent of their number, in the order named, and 64.5 and 63.1 per cent, in 1934, carried correspondent balances at this level.

Once more, analysis of the location of the banks reporting correspondent balances in excess of or equal to 20 per cent of all deposits reveals that they are for the most part situated in the smallest communities and are the smallest institutions studied. Of the 62 state banks reporting such balances, 58, or 93.5 per cent, were operating in communities with populations below the average for the group. Moreover, 49 of these 62 banks, or 79 per cent, were operating in communities or villages of less than 1,000. Nine of the twelve trust companies in this class were located in smaller than the average towns. The two highest percentages reported for national banks were from the two smallest banks in the group; one located in a village of 500 inhabitants, reporting a percentage of 60 per cent, while the other was a small national bank in a village of 800. Seventy per cent of the national banks with correspondent balances at or above the 20 per cent level were situated in smaller than the average communities.

When cash on hand and funds deposited with correspondent banks are considered together, the striking result of this analysis is the high degree of liquidity maintained by many of the reporting banks, particularly the smaller banks, in 1934. The reasons for this situation are found in the inability, and, in some cases, the unwillingness of bank officials in small communities to make local loans, as a consequence of the depression and other conditions (to be discussed later) that are tending to restrict the activity of the small town bank. Moreover, fear of a repetition of the conditions that caused so many failures during the last few years has resulted in an exaggerated desire for liquidity on the part of many bank officials. To these causes must be added the pressure brought by bank examiners upon country banks to liquidate "slow" loans.

The reporting national banks ordinarily clear checks for collection through the Federal Reserve Bank of the district; yet many of them maintain correspondent balances in the banks of the nearby trading centers, through which local checks are cleared directly.

CHAPTER V

POLICIES CONTROLLING THE MAKING OF LOANS AND OTHER SERVICES RENDERED BY THE REPORTING BANKS

It is the purpose of this chapter to discuss the policies controlling the action of the reporting banks when confronted with a demand for credit which they could not readily meet. The chapter will conclude with an analysis of other services rendered by the banks to the communities in which they are located.

There are various methods of procedure available to a bank when it finds itself in a position where ordinary demands for credit continue or increase while the ability of the bank to meet that demand is on the point of exhaustion. A bank in such a situation may sell securities held in the open market, recall funds deposited with correspondent banks, rediscount eligible paper with the Federal Reserve Bank of the district, provided the rediscounting bank is a member, or borrow from that institution upon its own promissory note, accompanied by adequate collateral, borrow directly from correspondent banks in nearby cities, or under certain circumstances, raise the rate of interest, recall loans already made and refuse to make additional loans.

An interesting result of the inquiry concerning the practices of the banks when loanable funds were exhausted was that many of the reporting banks located in the smaller communities had never found the demand for loans from customers sufficient to exhaust their lending power. This was true in spite of the fact that these banks were among the smallest studied. Of the 32 national banks reporting, six, or 18.8 per cent, stated that their loanable funds had never been exhausted. All of these were located in smaller than the average towns; five of the six had not varied their interest rates since the World War; and all six charged interest rates higher than six per cent. The same situation was found to exist among the smaller trust companies and state banks serving small communities. Many statements were given by the reporting officials describing this condition, of which the following is typical, "the community banks (a village of 400 population) have at all times in the past had more deposits than local demand for funds required, thus have to seek outside investments."

A frequently used means of obtaining funds in case of need by many of the reporting banks was the sale of securities. Of the

entire number of banks replying, 76, or 46 per cent, declared that they disposed of securities at times when additional funds were required. A much larger percentage of the state and private banks resorted to this method than did national banks and loan and trust companies: the percentages for the state and private banks amounted to 51.7 per cent and 60 per cent respectively; and for the reporting national banks and loan and trust companies, to 38.5 per cent and 44.4 per cent, in the order named. The practice of selling securities as a means of increasing local funds is not necessarily a constant practice on the part of the banks replying. Its use depends upon varying conditions, such as the state of the bond market, yield on bonds as contrasted with local interest rates, maturity of securities, and the rate at which funds may be borrowed from correspondent or Federal Reserve Banks. Ordinarily, banks possessing marketable securities would not part with them at a substantial loss, provided their investment status had not changed. This is illustrated by the following typical statements: "short term Government securities would be sold first, bond market conditions would then govern actions," and "if the security market is off so a loss would be incurred on the sale of securities, we borrow."

The most popular method of securing additional funds in time of need among the reporting banks was the practice of merely recalling funds deposited with correspondent banks. As has been indicated, the prevailing interest rates charged by the reporting banks was from 6 to 8 per cent. The advantage of recalling deposits from correspondent banks seldom paying more than two to two and a half per cent upon such deposits, to meet a demand from local borrowers, is obvious. Of the 162 banks reporting, 101, or 62.3 per cent, replenished local funds by the practice of recalling correspondent balances. Twenty-five of the 30 national banks replying, or 83.3 per cent, used this method. Seventy per cent of the private banks, 69.5 per cent of the state banks and 66.6 per cent of the loan and trust companies reporting resorted first to the recalling of funds on deposit with correspondent banks. An important reason for the larger percentage of the national banks making use of this method is the fact that greater lending is permitted by their lower reserve requirements. Among the banks not using this method, correspondent balances were maintained at a relatively lower percentage of all deposits.

Quite a diversity of opinion and practice existed among the reporting banks concerning the desirability and use of borrowing either from the Federal Reserve Banks through the rediscounting of eligible commercial paper and direct collateralized loans, or borrowing from correspondent banks. This diversity of opinion

and practice existed even among the national banks, where it might be expected that frequent use would be made of the credit facilities of the Federal Reserve Banks. Nine of the thirty reporting national banks stated that they made use of the privilege of rediscounting with the Federal Reserve Bank as a means of replenishing exhausted funds. All of these nine banks were among the largest reporting. A definite opposition to rediscounting seemed to exist among the officials of national banks serving the smaller communities. One official of a small national bank in a village of 300 population stated, concerning the practice of rediscounting, "only twice, several years ago." A second small bank replied, "we did before the War, not since." Many similar statements were made by officials of the smaller national banks. Among the larger national banks, however, there seemed to exist a definite satisfaction with the process of rediscounting. One official stated that "the Federal Reserve seems to be the logical place to go, have been well taken care of"; another replied, "always had very fine service from the Federal Reserve Bank of Chicago; never felt the need to ask any other bank for rediscount."

Only one state bank and two loan and trust companies stated that they ever made use of the rediscount facilities of the Federal Reserve System. Moreover, only 20 of the 87 reporting state banks, or 22.9 per cent, made a practice of replenishing funds to meet additional demand for loans through the process of borrowing from correspondents. Only three of the 21 reporting trust companies and two of the twelve private banks borrowed from correspondents. Again, repeated statements indicated that many of these banks likewise view the practice of borrowing from other banks as an unmitigated evil. A typical reply from a trust official succinctly stated "a bank has no business borrowing or rediscounting." An official of a small state bank voiced a common idea, "to borrow funds to loan out is a dangerous precedent....."

Among the smaller banks of all types replying, there seems to have been a very definite disregard of responsibility to come to the assistance of their customers during periods of increased demand for loans, no matter how justifiable such loans might be, when local resources of the bank were exhausted. Instead of selling securities or borrowing from correspondents, several of the smaller banks followed the policy of ceasing to lend and reducing loans outstanding.

An important reason for the attitude of hostility to rediscounting existing among the reporting banks is the publicity and indirect control of their operations involved in rediscounting. The Federal Reserve Banks accept only certain types of paper for rediscount, which puts indirect pressure upon the banks in need

of rediscounting to make loans that are eligible. Moreover, the process of rediscounting and borrowing involves the revealing of information concerning internal operations and policies. This is contrary to the individualistic philosophy of the typical small town banker. The opposition is accentuated by a widespread lack of appreciation among small banks of the functions of a banking system as over against the operation of an individual unit bank. The typical small town banker looks upon his business only from the individualistic, competitive, profit-making viewpoint, and never as a business imbued with great social responsibility and interest, through its power to create and destroy the most important element of the nation's circulating media. With this viewpoint, it is inevitable that the officials of small country banks would oppose any form of external control. There does exist, however, an element of possible danger to local banks in the process of rediscounting in the fact that contingent liabilities are increased.

Effect of General Business Conditions upon Lending by the Reporting Banks

Of the 146 banks reporting on the subject of regulation of lending policies in accordance with general business conditions, 68, or 46.5 per cent, made no attempt to curtail or increase loans according to general business developments in the country at large. In the process of controlling credit extension, the reporting national banks paid more attention to business conditions than any other group. Thirteen of the 32 national banks reporting, or 40.6 per cent, made no attempt to control credit given in the light of outside conditions. Forty-five per cent of the reporting loan and trust companies acted similarly. Forty of the reporting state banks, or 47.4 per cent, were in the same category. Seven of the ten private banks replying, or 70 per cent, extended credit regardless of general business conditions.

Analysis of the location and size of the banks reporting that disregarded external business conditions in the making of loans indicates that, typically, they were the smallest banks of their respective groups and were located, for the most part, in small rural communities. Ten of the 13 national banks in this classification, or 76.9 per cent, were operating in communities smaller than the average for the reporting national banks. Five of these banks were located in villages of less than 1,000 inhabitants and had the minimum capital outstanding of \$25,000.

Only two of the nine trust companies denying any connection between their loans and general business conditions were

located in towns of more than 2,000 population; while only one reported capitalization in excess of \$50,000. It is even more typically true in the case of the reporting state banks that the banks which operate without notice of what is happening in business and economic development outside their local community are the smallest banks, located in the smallest towns and villages. Of the 40 state banks in this group, 30, or 75 per cent, were located in villages of 1,000 or less, and 19, or 47.5 per cent, operated in tiny villages of under 500 people. Moreover, 28 of the 40 state banks in this classification operated with the minimum capital of \$25,000 permitted by law. Only three presented capital stock outstanding in excess of \$50,000.

It is altogether probable that very few, if any, of the officials of these banks disregarding general economic conditions would contradict the statement that local business conditions are governed to a marked extent by the state of economic activity in the nation as a whole.

From the standpoint of the 78 banks of various types that did consciously curtail or increase local loans according to general business conditions, it is not surprising to learn that the most important external factor affecting the process of making loans was the market value of livestock, grain and other agricultural products. In fact, all external conditions impinging upon the welfare of the agricultural industry were of paramount importance to many of the officials of the reporting banks.

Several of the reporting banks included credit and money conditions among the general business conditions that were of importance in governing lending policies. The economic and political situations of the country were watched closely by many bankers as guides to lending policies. One official wrote, "we are reducing our local loans as far as possible and waiting to see what develops nationally." Another policy of another bank was explained as follows: "it depends on the outlook of conditions of the country in general, and considering this outlook the amount of money we should loan out under such conditions."

One of the most frequently mentioned external conditions mentioned that affected lending policies of the present and immediate future was the restrictive attitude of various government agencies. It was upon this issue that some invective and much bitterness was expressed by the reporting banks. Space will not permit, and in some cases, the language used will not allow the recording of the multitude of statements expressing hostility toward certain phases of Government regulation as deterrents to lending. A national bank official expressed the attitude of many others in declaring "owing to the domineering attitude of bank

examiners, we were forced to collect 40 per cent of loans last year." Another official offered his explanation of the Governmental attitude as "the national examiner is forcing us to curtail loans; we think to get a surplus of funds to help finance the Government by the purchase of Government bonds with the surplus funds." A third wrote, "since the guarantee of deposits, it is almost impossible for us to make loans on account of restrictions, red tape and rules."

Additional Services Extended Customers by the Reporting Banks

Although the events of the last few years may have injured somewhat the prestige of the banking profession, it is still true in the small communities served by the reporting banks that the banker is looked to by the other members of the community as a source of information and advice, not only upon financial matters but upon personal affairs. This attitude is explained by the fact that the local banker ordinarily possesses a better than average education and is generally found closely connected with all political, civic and educational movements occurring in his city or town.

As a consequence of custom and competition, the banks of these communities, moreover, perform a large number of miscellaneous services for their customers and the public, as devices for securing additional business, some of which are charged for, others not. In spite of the growth during recent years of the practice of attaching service charges to services performed by banks, the reporting banks still perform a large number of incidental services without charge. Forbidden by professional ethics from extensive advertising, many bankers consider the host of miscellaneous services performed as a substitute.

In order to discover the type and amount of incidental services by the smaller banks of Indiana, the banks replying to the questionnaire were requested to list the various miscellaneous services performed for the members of the communities which they served. The result was a surprising list of minor functions performed. These services included aid in making out tax reports to both state and federal governments, aid in installing and improving accounting systems and other records, purchasing securities, buying livestock for breeding purposes, providing of safety deposit facilities, drawing of contracts, wills and other legal instruments, aid in the organization and promotion of various civic and educational movements, and a multitude of other services ranging from the most minute individual service to those pertaining

to the entire community. The services mentioned most frequently are listed below.

TABLE XXII
PERCENTAGES OF REPORTING BANKS RENDERING
VARIOUS SERVICES TO CUSTOMERS

Type of Service	National	State	Trust	Private
Safety deposit	100.0%	93.1%	90.0%	81.8%
Purchasing securities	84.3	83.9	80.0	90.9
Reporting and collection of taxes	64.5	79.3	60.0	100.0
Aid in accounting	61.3	57.4	45.0	72.7
Aid in purchasing livestock for breeding	48.4	49.4	35.1	63.6
Aid in drafting wills and other instruments	48.4%	56.3%	50.0%	45.4%

In addition to these specific services mentioned in the table above, there was a multitude of other aids and services mentioned less frequently. It is virtually impossible to classify them or to determine accurately what proportion of the reporting banks perform them. In the smaller communities, the local banks were called upon to render an almost unbelievable variety of services in addition to those listed, ranging from the running of errands to advising concerning religious and political problems of the community. A banker operating in a village of less than 900 people summarized, in all seriousness, the many functions performed by his bank as follows, "the country banker must be everything from wet nurse to Father Confessor in his community."

CHAPTER VI

EFFECTS OF ECONOMIC INTEGRATION UPON THE REPORTING BANKS

As a part of the study of the operation of small country banks in Indiana, there remains to be discussed the effect upon these institutions of the modern tendencies toward binding together of communities and business organizations into larger economic units. In analyzing the effects of economic integration, the process will be divided into two parts; first, the results of community integration upon the reporting banks produced by the development of highways and increased use of automobiles; and, second, the effects of the growth of large scale industry in the form of combinations of manufacturing plants and particularly of commercial business units into chain organizations.

Effect of the Development of Highways and Increased Use of Automobiles upon the Reporting Banks

During the period from 1914 to 1930, the mileage of surfaced roads in the rural districts of Indiana increased from 30,962 to 51,314 miles, constituting an increase of 65.7 per cent. The number of automobiles registered in Indiana in 1910 numbered 45,000. By 1930, this figure had increased to 875,763, an increase of 1,846 per cent. Since the obvious effect of these two developments has been to widen marketing areas and broaden the sphere of economic influence of larger communities, to the disadvantage, ordinarily, of the smaller communities, it is pertinent to inquire concerning the effect upon the business of commercial banks located in the smaller towns and villages of the state.

Of the entire number of reporting banks, 135 gave definite answers concerning the effects of the rapid development of roads and the increased use of automobiles. Of this number, 53, or 39.3 per cent, stated unequivocally that their business had been injured by automobiles and good roads; 38 of the 135 banks reported that they were unaffected, while 44 had experienced an increase in business as a consequence of such developments, or 32.6 per cent.

Upon more detailed analysis of these figures, it is discovered that only two of the 27 national banks replying declared

that they had been injured in that business had gone elsewhere or to larger communities. Both of these banks were operating with minimum capital and were located in villages with less than 1,000 population--one in a village of 300 and the other in a small town of 800 people. Of the 25 remaining, 12 reported an increase in business, seven of these being situated in cities ranging from 5,000 to 45,000 inhabitants, and, with one exception, the remainder operated in towns of 1,500 or more population. Of the 13 banks feeling no effects, only two were operating in communities with less than 2,000 people.

Eight of the 17 replying trust companies, or 47.1 per cent, reported injury from good roads and automobiles. Every one of the eight were located within easy driving distance of Indianapolis or some one of the other eight cities of the state with more than 50,000 population. Only one of the trust companies suffering loss was located in a town of more than 6,000. The four trust companies reporting benefits were located in cities of 28,000, 12,200, 5,100 and 2,500 population.

Eighty-one state banks replied concerning the effects of automobiles and good roads. Thirty-six of this number, or 44.4 per cent, discovered that their business had been injured. Analysis revealed that 24 of the 36 banks, or 66.6 per cent, were operating with the minimum capital permitted, while 29, or 80.5 per cent, were situated in villages of 1,000 or less. Fifteen of these banks were located in villages of 500 population or less. Moreover, all of the 36 injured banks were located in towns on hard surfaced roads within 25 miles of larger centers.

Seven of the 18 state banks reporting increased business as a result of improved transportation facilities; three were operating in cities of 12,000 or more population; seven in towns of 5,000 or more and only two were situated in villages of 500 or less. The last two banks mentioned were situated in the more sparsely settled areas of the state.

Since the reporting private banks were typically located in the small villages of the state, it is not surprising to discover that seven of the ten private banks replying found their business adversely affected by the increasing use of roads and automobiles by their customers. Only one private bank, situated in a town of 3,225, declared that its business had been increased.

Table XXIII on the following page summarizes in terms of percentages the effects of improved transportation on the business of the reporting banks.

As this analysis indicates, the reporting banks injured by the increasing community integration resulting from the development of good roads and the extensive use of automobiles were,

TABLE XXIII

PERCENTAGE DISTRIBUTION OF REPORTING BANKS ACCORDING
TO THE EFFECTS OF THE DEVELOPMENT OF GOOD
ROADS AND AUTOMOBILES UPON BUSINESS

	National	State	Trust	Private
Injurious effects	7.4%	44.4%	47.1%	70.0%
No effect felt	48.2	33.4	29.2	20.0
Business increased	44.4	22.2	23.7	10.0
Total	100.0%	100.0%	100.0%	100.0%

typically, small institutions operating with minimum capital requirements and located in the smaller towns and villages of the state.

Concerning the nature of the detrimental effects resulting from good roads and automobiles, there is some diversity of opinion among the reporting banks. Most of the officials of the injured banks agree that the most serious consequence was the tendency of business to drift to nearby cities. Of the many statements made to this effect, the following is typical, "good roads and automobiles have been shifting business to larger cities." Another group of banks suffering detrimental effects asserted that it is due not so much to the tendency of clients to go elsewhere, but a large number of their customers have been induced to spend their savings and go into debt for automobiles on the installment plan, thereby destroying their credit ratings and their value to the local community and to the bank as customers. A variation of this attitude is that the automobile has caused many customers to spend too much time in travel "when they should be at work."

A third detrimental effect stressed by several reporting banks was that automobiles and good roads have made the way easier for the operation of bank robbers. They point out that the small country bank is peculiarly defenseless against such attacks and that the frequency of their occurrence has resulted in higher insurance premiums charged, thus increasing operating expenses.

From the viewpoint of the large number of national banks and larger state banks and trust companies which reported that their banking business had derived benefits from improved transportation facilities, the specific advantage unanimously given was that not only had the banking area and sphere of influence of

the bank itself been widened, but that their local customers engaged in retailing and other activities had enjoyed wider markets.

Effect of the Growth of Chain Stores upon the
Business of the Reporting Banks

During the decade after the close of the World War, the state of Indiana experienced a very rapid increase in the number of chain stores operating in the state. According to the best estimates and most reliable figures available, there were 1,300 units of chain organizations of all types in the state in 1920.¹ By 1934, this figure had mounted to 8,200 chain store units, contrasting with approximately 53,000 single stores in the state. In the latter year, the chain stores were operated by 1,650 companies or individuals.

With the exception of gasoline filling stations, the location of the large majority of chain units operated in Indiana is confined to communities with populations in excess of 1,500 inhabitants. Consequently, many of the smaller towns and villages where reporting banks were located possessed no chain organizations. Obviously, banking institutions existing in such small communities suffer no direct good or ill effects from the operation of chains.

In addition to the growth of large scale retailing, there has developed a tendency toward the growth of large scale manufacturing during the last two decades. Most of the manufacturing plants of the state, however, are located in the larger towns and cities and not in the smaller communities, where most of the reporting banks are situated.

Concerning the effects of the growth of chains and other forms of large scale business organization, 148 of the reporting banks replied. Of this number, only two banks, one a national bank and the other a trust company, declared that their business had been aided by the organization of chain store and other similar organizations. Fifty-seven, or 38.5 per cent, stated definitely that their operations had been injured. Of the 32 national banks, 13 reported injury as result of the advent of chains; 32 of the 90 state banks, nine of the 21 trust companies and two of the private banks declared that their business had suffered from the same cause.

Judging from the replies of the reporting banks, the

¹Compiled from the records of the Gross Income and Store License Division of the State of Indiana.

injurious effects suffered by the small town banks, as a result of the establishment in the community of chain stores and similar organizations, take the form of decreased loans. Several of the replying banks mentioned the fact that chains and branches frequently deposit funds in the local bank but do not borrow. The reason for this condition is that the credit requirements of chain and branch organizations are negotiated and arranged through the central offices, located, as a rule, in cities beyond the scope of this study. The fact, moreover, was brought out that the competition of chain units frequently results in decreased business on the part of the remaining independent stores of the community, which, consequently borrow and deposit less with the local banks.

Causes of Bank Failures as Stated by the Reporting Banks

Among the external causes of bank failures beyond the control of management listed by the reporting bank officials, the increasing use of roads and automobiles taking business elsewhere and the establishment of chain and branch organizations in the community were not specifically mentioned. The predominant cause of the multitude of failures in recent years in the minds of the reporting officials was bad management on the part of officers and directors. Under the heading of bad management, the replying officials listed such items as the making of loans without adequate security, the lending of bank funds to friends, relatives and bank officials, investment in securities without proper investigation, the making of too many real estate loans at excessive evaluations and too heavy investment in buildings, furniture and fixtures. Again, bad management was attributed to the fact that many bank officials were ignorant of sound banking principles. Among the many quotations on this subject, the following is typical, "too many people in the business that did not understand banking," and "too many incompetent bankers."

Table XXIV on the following page classifies the replies of the 161 banks reporting on the causes of bank failures into internal and external factors.

The most frequently mentioned external cause of failure was the excessive decline in value of agricultural land and commodities since the World War and during the depression in particular. Not only were the banks affected by declining agricultural prices, but the depression years brought rapid declines in security values bought by the small banks upon the advice of correspondent banks and bond houses. Others mentioned severe competition among banks, promoted by the excessive chartering of new banks by

TABLE XXIV

CAUSES OF BANK FAILURES IN INDIANA AS STATED BY SMALL
BANK OFFICIALS REPLYING TO QUESTIONNAIRE

Type of Bank	Bad Management	External Causes beyond Control of Management
National banks	19	10
State banks	54	48
Loan and trust companies .	10	10
Private banks	5	10
Total	88	78

the state authorities.

No bank mentioned as cause of failures the decreasing ratio of capital to deposits, the lack of adequate supervisory machinery, the lack of any organization to come to the aid of small non-member banks in distress, nor the almost universal tendency of the banks of the state to pile up current liabilities payable on demand, while depending for solvency upon assets which could be liquidated in an emergency only at large sacrifices.

CHAPTER VII

AN APPRAISAL OF THE OPERATION AND PRACTICES OF THE REPORTING BANKS

It is not the object of this study to heap criticisms upon the practices and policies of the bankers and banks that have been courteous enough to supply the data upon which it is based, but to come to unbiased conclusions, after careful analysis of the policies and outlook of the smaller country banks of Indiana. These conclusions must be arrived at not only in the light of internal practices, but also in the light of general economic developments affecting the communities in which these institutions are located.

It must be remembered that more than three-fourths of the banks upon which this analysis is based are located in small rural communities of less than 3,000 population and do business very largely with agricultural interests. Economic developments, therefore, which affect the small rural community and the agricultural industry are reflected in the operation of the banks of the communities.

The conclusions arrived at in this final chapter will be based upon an analysis of two sets of conditions presented in the course of the study; first, external developments affecting the country bank and second, internal practices and policies.

External Developments Affecting the Reporting Banks

External economic developments impinging upon and affecting the practices of the reporting banks may be divided, in turn, into two groups--those conditions and developments that are of a long-run or secular nature and those of a cyclical character.

The long-run secular developments include, first, the definite tendency on the part of the population of Indiana to become more and more urbanized during the period since the beginning of the century. As has been pointed out in the original study, the increasing urbanization of the state's population, however, has not been equally spread among the cities, towns and villages of the state. The industrial centers, such as Indianapolis, Gary, Terre Haute and others have grown rapidly, while the towns and

villages of the state have tended as a group to grow smaller or remain stationary, as far as population is concerned. Inevitably, the banks of the towns and villages have suffered a decrease in the opportunity to lend.

Again, as was pointed out in the preceding chapter, a large degree of community integration has occurred in the state, as a consequence of the development of better roads and the increased use of automobiles. These developments have tended to cause the inhabitants of rural communities to go to the larger cities to buy and sell, to obtain amusement and, frequently, to live. The result has been that the small town merchant and other business organizations have suffered materially and in many cases have closed. A typical statement of an official of a small town bank replying expressed the deterioration of the small community in the following terms: "the country town is suffering from dry rot." Consequently, the country bank has again lost a portion of its clientele.

A third external development reacting unfavorably upon the operations of the rural bank has been the entrance into the towns and larger villages of the state of chain retail stores and branch organization, which tend to take business away from the local customers of local banks. Although these institutions frequently arrange to make deposits with local banks, they seldom borrow.

The field of rural banking, moreover, has been invaded to an increasing extent during the last two decades by lending institutions organized and supervised by federal and state governments. The state and private banks of Indiana have for decades extended credit to farmers on the security of farm mortgages, running from three to five years, frequently renewed, and bearing interest rates ranging from six to eight per cent annually. With the organization of the Federal Land Bank System, in 1916, to make longer term loans at lower rates, the Intermediate Credit Banks, in 1923, making loans not only through the medium of commercial banks, but also through building and loan associations, savings banks and farmers' cooperative associations, the Federal Home Loan System, in 1932, the Home Owners Loan Corporation of 1933, and other governmental lending agencies, the rural banks have found an already diminished field of activity invaded and opportunities for loans decreased.

A final external secular condition affecting adversely the operations of the reporting banks has been the steady and prolonged decline in agricultural prices since 1921. One of the most frequently mentioned causes of failure of banks in the state by the reporting banks was this fact. In the face of a combination

of conditions including an inelastic demand for farm products, curtailed foreign markets, a decreasing rate of growth of domestic population and the increasing amount of capital investment necessary to successful modern farm operation, it does not appear that the banks and farming communities of Indiana, in spite of governmental aids and subsidies of various types, can expect any marked revival of small scale agriculture within the state. If in the future large scale farming should develop, it would be of doubtful benefit to the type of banks discussed here.

The depression phase of the business cycle has accentuated the effects of declining prices and extended it to include securities held by the reporting banks and has resulted in multiplied failures and an increasing degree of contraction in rural bank operations.

Another consequence of the present depression phase of the cycle which will in all probability become a permanent development, is the increasing amount of social regulation "inflicted" upon the country banks, not only by the state government--in the case of state chartered and private banks--but likewise by the federal government, through the operation of the Reconstruction Finance Corporation and the Federal Deposit Insurance Corporation. This increased amount of control has resulted in more frequent and detailed examinations, more frequent and voluminous reports of operations by the banks, the establishment by the banks of more accurate and complete accounting systems and the segregation of records of different activities engaged in. Additional help and time has been made necessary as a consequence of more intensive social control, thus increasing operating costs of the rural banks. The situation has been complicated by a considerable amount of duplication of reports and examinations occurring through the non-integration of federal and state control. It may be true that the position of the small bank will eventually be strengthened as a result of increased social control, but the immediate result has been an increase in costs of operation and the creation of a source of vexation.

Internal Developments Affecting the Reporting Banks

In attempting to summarize the internal practices and policies of the reporting banks and to arrive at conclusions concerning them, it must be remembered that these banks are, typically, small banks, with small amounts of capital and surplus. As has been shown, the large majority of the banks replying to the questionnaire operated with the minimum amounts of capital permitted

by law to each group. These institutions maintained deposits both in the period prior to 1929 and in 1934 at a ratio to capital stock exceeding nine to one. The combination of these two conditions--small minimum amounts of equity interest and a high rate of deposits to capital stock outstanding--produced a situation wherein the small equity interest served as an inadequate shock absorber between the safety of deposits and the dangers produced by changing economic conditions. Moreover, the small amounts of capital invested by owners in relation to liabilities created a condition wherein losses on comparatively small loans would very seriously impair accumulated capital and surplus and thus further affect the already weak position of depositors.

One of the most persistent arguments for the retention of the local unit bank as the foundation of the American banking system has been the contention that these banks collect local funds and make them available to local industry. With regard, however, to the group of small unit banks upon which this study is based, only slightly more than one-half of the funds available to them were loaned locally, even in the period prior to the present depression--less than one-half in 1934--the bulk of the remainder being lent abroad in the form of investments in securities of various types.

One of the most serious weaknesses against which the small bank, as exemplified by the reporting banks, must contend is the fact that they have little opportunity to diversify local loans. In the nature of their situation, they must lend to agricultural interests and, as a consequence, be subject to the many vicissitudes which beset that industry. It is noteworthy that the group of reporting banks lent less than four per cent of all loans made to manufacturing concerns and less than seven per cent of all loans to merchants in 1934. In 1929, the percentages for such loans were only slightly in excess of those mentioned. The remainder of loans made were for agricultural purposes. One of the outstanding differences between the small country bank typical of this group and the large city bank is the extremely small volume of bona fide commercial banking business done by the former. In fact, from the standpoint of loans made, the term "commercial bank" should not be applied to most of the banks of this group.

In lending primarily to agricultural interests, there is little opportunity to diversify loans as to maturity in order to provide a regular return flow of funds with which to meet demand deposit obligations. Such loans are made according to the seasonal needs of the industry and, therefore, are made at certain periods of the year and collected together at another period. It is, then, not surprising that no attempt was made by the reporting

banks to control the maturities of loans. Neither was there found any widespread attempt to control the inflow of funds by the purchase of commercial paper with varying maturities.

Another outstanding characteristic of the lending policies of the reporting banks was the comparatively large volume of loans made for long term capital purposes. Many of the banks indicated that more than one-half of all loans granted were made for such purposes. This was true before and during the depression. It cannot be denied that long term capital loans are greatly in demand among the customers of the typical country bank, and, for the most part, are economically justifiable demands for credit. The possibility always exists, moreover, that the working capital loans made by banks in this group may become long term loans, since the majority are made to agriculture and their liquidity depends upon farm income and inventories. Due to the nature of the industry, such loans are often renewed again and again. These frequent renewals may be due to unavoidable errors, first on the part of the borrower in estimates of future income, and second the lending bank may have erred in the calculations on which the loan was based. Renewals may be due, however, to tacit understandings between the lending bank and borrower that a capital loan was nominally to be short term but actually was to be renewed indefinitely.

Another characteristic of the operations of the reporting banks to be considered in connection with the loans made is the type of deposits held. For the reporting banks as a whole in the period prior to 1929 and in 1934, slightly less than one-half all deposits were in the form of time deposits, against which smaller reserves were permitted. Many of the reporting banks held time deposits far in excess of fifty per cent of total deposits. As a result of custom and competition, it was customary to pay out time deposits on demand, thus causing the economic status of such deposits to resemble demand deposits. In other words, all liabilities of the reporting banks were current and subject to demand withdrawal.

The combination of these two conditions, wherein all liabilities were current while the bulk of loans made by the reporting banks were of long term, non-shiftable, non-marketable capital nature, produced a situation where the surprising thing is that so many of the small country banks have survived. The primary difficulty with the type of loan made is not so much that they are long term, but that they cannot be shifted readily to other banks in time of need and do not possess an organized market in which they can be disposed of easily. Membership in the Federal Reserve System would have helped the typical reporting bank very

little, since, as that system has been organized and operated, it could not have made loans or rediscounted the bulk of the assets of the reporting banks. The conclusion is difficult to escape that the small country bank, typical of the group reporting, with its comparatively small amount of equity interest, large amount of current liabilities, and with a large portion of its assets of a long term, non-shiftable capital nature, is not best fitted to make the type of loans most frequently demanded by their customers and justified by the economic conditions of the communities served by them. The organization and operation of the typical reporting bank seems to introduce a very definite element of risk into the banking system of the country and the communities which they serve. The ever present danger of insolvency of these institutions is a threat not only to local depositors, but to the entire economic system, through the sudden contraction of loans of the circulating media and the danger of involving banks elsewhere. The depositing of funds in such banks is a hazardous venture. If the public wishes to retain them it must be willing to pay the high interest and service charges which enable them to exist and to experience frequent and disabling losses through insolvency.

One of the traditional arguments propounded by the adherents of the small independent unit bank, exemplified by most of the reporting banks, is that these institutions have been the leaders and the directors of the development of local resources, seeking out and extending credit to those individuals and business organizations of the greatest ability and promise, directing capital into those industries with the brightest prospects, discouraging undue expansion and urging on the unduly timid, all in the light of existing economic conditions. There appears to be some evidence, however, in the present study to indicate that the reverse may be true, that the typical small country bank has been led rather than leader, that the country banker, like the chameleon, may have merely responded to surrounding conditions. With all due respect and credit to the individual bankers who have been exceptions, the typical country banker seems to be unequipped by training and experience to do much more than be optimistic when the community is optimistic and pessimistic when the community is pessimistic, and to act accordingly. Moreover, in his capacity as a creator and destroyer of circulating media, he has been in a position to accentuate by his actions the immediate tendency, whatever it might be. In other words, the country bank has been in a position to provide a quality which might be called perverse elasticity to the circulating media.

The evidence contained in the present analysis which seems to support the conclusion that the typical country bank is a

follower rather than a leader in the economic development of the community includes, first, the price or interest rate charged is not varied by the typical bank with changing conditions affecting the demand for and supply of funds available. The interest rate charged has long been accepted as an instrument by the variation of which banks can attempt to control the expansion and contraction of business activity. There is no evidence whatever available that the reporting banks have sought to do this. The primary factor controlling the rate of interest charged by the reporting banks apparently was custom--many of the banks replying had not varied their interest rate literally for decades, regardless of the stage of the business cycle or the intensity or lack of local demand. The only condition that seemed powerful enough to induce many of the banks replying to change their customary rate was that internal operating costs of the lending bank were rising. The change described most frequently was an increase in rates. In specific cases, the rate was increased in face of declining demand.

Another condition tending to support the conclusion that the country bank has not been the leader in the economic development of the local community that its proponents claim for it, is the fact that during the period before 1929 and thereafter, the reporting banks loaned a progressively smaller proportion of resources locally. Loans abroad in the form of investments in securities grew rapidly in amount and relative importance. In fact, among the banks replying there were institutions which stated definitely that they preferred investing the resources at their disposal in other than local loans. Many of the reporting banks had such large percentages of all funds invested in government, municipal and other securities that they resembled trusts rather than commercial banks.

In the light of external economic and social developments resulting in the declining importance of the rural community center, the establishment of an increasing number of governmental agencies designed to care for the credit needs of agricultural interests, the increasing burden of state and national supervision--highly desirable from a social standpoint, but definitely adding to the cost of small banks--it becomes increasingly apparent that the operation of the small unit bank, typical of most of the reporting banks, has developed into a more and more precarious undertaking.

When, to mounting difficulties imposed by external conditions are added internal rigidities in operating methods and practices, managements frequently without adequate professional training and experience, a considerable degree of hostility to any form

of integration into a banking system, plus other anachronistic practices, the economic justification for the continued existence of the country bank in its present form is impaired. And, finally when the fundamental weakness of the typical reporting bank is considered, it is discovered that it has built up a large structure of current liabilities in the form of demand deposits and time deposits that are the equivalent of demand deposits upon the basis of assets composed largely of loans that are of a long term capital nature and security investments that fluctuate with varying interest rates and cannot be liquidated without loss in time of emergency.

In the light of these conditions, the conclusion cannot be avoided by the present writer that the typical country bank, exemplified by the majority of those reporting, organized and operated as it is today, is an institution that is outliving its usefulness and, like the rural general store and similar pioneer institutions, is on its way out. It is the considered opinion of the writer that its eventual passing in its present form should be hastened, since it introduces a needless element of risk into the economic system. It is possible that the rural bank may be reorganized into a mortgage institution, receiving no demand deposits and making loans upon real estate and chattel mortgages from funds secured from the sale of capital stock and debentures. Organized on some such basis, the rural bank could continue to meet without danger to itself and others the justified demand for long term capital credit so typical of the agricultural industry.

